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Bay Area Council Initial Comment to California Market Advisory Committee regarding the Form and Structure of a Cap and Trade Program and implementation of AB 32:

RE: CAP-AND-TRADE DESIGN

The environmental integrity of the cap must be paramount in tandem with assuring that the measures to achieve emissions reductions that maximize cost effectiveness and technological feasibility.

The central feature of a cap and trade program is the creation of an overall, quantitative limit on emissions that can be enforced on emitters by requiring allowances. Therefore the cap and trade system must be designed and based on accurate underlying emissions data regarding baseline quantity and changes in emissions quantity over time, and with an ability to monitor and enforce the allowances in emissions for each capped entity and sector. The integrity of the cap is paramount. Uncertainty in what the cap should be, how it is determined and what value is attributed to the allowance must be resolved up front. The amount and distribution of the emission reduction allowances should be done in the context of other policy changes aimed at reducing greenhouse gas emissions.

The Market Advisory Committee report should clearly address ways that the environmental integrity of a cap-and-trade program can be guaranteed.

The Bay Area Council recommends that the Cap and Trade system should have the following elements and avoid the pitfalls of certain structures found counter-productive in other cap and trade systems.

1. The cap should be set at a level to achieve meaningful emission reductions.
    a. Establish Allowances the Result in Reductions: The cap should achieve reductions from its inception. In order for the cap and trade market to effectively contribute to

meeting the 2020 goal, the cap has to be set low enough to achieve meaningful emission reductions. Allowances should be based on actual current need and then be progressively ratcheted downward based on the installation of cost effective and available technologies and clean fuels. Note, the RECLAIM program stands out as a particularly stark example of a program that failed to deliver the appropriate environmental benefits, at least in its early years when the cap did not require any reductions.

b. Coverage of A Cap: The broadest selection of sectors to be capped must be determined based on a criteria that includes whether the sector contributes a significant amount of greenhouse gas emissions and that the cap is administratively simple with regard to collecting and monitoring the information of relevant emissions. Not all sectors of the economy should included in a cap and trade program; however all sectors should carry their fair share in meeting the objectives of reducing greenhouse gas emissions.

c. A Safety Valve or waiver from the cap on emissions allowed introduces significant uncertainty into a cap-and-trade system. A relatively loose safety-valve sends "uncertainty" waves into a new market and will be counterproductive to return on investments for innovations and economic growth in clean tech and energy efficiency sectors designed to provide solutions to global warming. The cost-effective nature required for the implementation of the emission caps minimizes the need for expanding the safety valve provision beyond providing the Governor power to delay compliance for a year under extraordinary circumstances.

   However, there should be some consideration to options that would cap the price of allowances when they become unreasonably high due to a new market that is learning its way. The Safety Valve provisions must not have the effect of increasing emissions allowed under the program beyond the allowances. Options that should be investigated include:

   i. Reserve Allowances: Do not distribute all allowances in one year, hold a reserve that could be issued based on prices level, (e.g. issue 90% hold 10% certain back)

ii. Banking of Emissions: allow companies to dip back into reserves of emissions saved in past years in a future year where prices for carbon credits have gone above a certain threshold
iii. Average compliance with allowances over Multi-Year period: for instance, 3 three year compliance period could provide cushion on price volatility management in a given sector due to shortages of particular product or fuel

2. The Method to Distribute the Allowances
   a. The policy of distributing allowances should encourage the reduction of emissions
   b. Free distribution of allowances for all allowances has resulted in historic polluters achieving windfall profits, and higher prices to everyone else, in the case of Europe.[1] There may be selective sectors that should receive free allowances (grandfathering) or some proportion of allowance to offset potential costs that will otherwise be immediately passed to customers, such as in the Energy and Utility Sector.
   c. The Cap and Trade market would work most fairly and effectively by having firms bid for their permits instead of being allowed to lobby government for them free of charge. The impacts of an auction on the economy should be evaluated to assure that it does create an unfair economic burden on companies doing businesses in California. There continues to be debate as to whether an auction or free allowance is the best approach.
      i. Auction provides an efficient means to allocate emission allowances based on actual demand
      ii. Revenues obtained by auction can be used to address economic inequities that dis-proportionally impact low income residents, and address environmental justice concerns
      iii. Auctioning is simpler to administer and avoids the government setting prices in the alternate have the government settle conflicts about what businesses should receive free allowances and how much
      iv. Auctioning creates the right incentive structure and a level playing field

[1] *Wall Street Journal*, "For German Firms, New Emissions Caps Roil Landscape," 9/11/06; *The Economist*, "How America is likely to take over leadership of the fight against climate change; and how it can get it right," 1/25/07

- Auctions reward early action. Those that undertake early action will benefit from being able to purchase fewer allowances than if the early action had not been taken.
- Auctioning does not disadvantage new entrants who would seek to enter a market.
- Auctions lead to early and better price discovery (understanding of the true value of an allowance), reducing unnecessary volatility in the market.
- Auctions avoid the perverse outcomes that arise from giving away pollution based on historical patterns ("grandfathering") in which firms that pollute the most are rewarded by receiving the most allowances.

Importance of designing a program that works for California and is integrated in a Robust Global Market on Carbon Emissions

It is important to develop a cap-and-trade program that would mesh well with a regional, national program and international program that trade carbon credits. It is of vital importance that the program work well for California and provide maximum health benefits to the residence of the state in terms of emissions reduction. It is also important to acknowledge that greenhouse gas emissions are a global problem, and reducing the net emissions anywhere in the globe is a benefit, so long as they are real reductions that can be verified. The offset market should be as broad as feasible to make for a robust cap and trade market that achieves reductions in greenhouse gas emissions.

The cap and trade system should allow flexibility for a certain proportion of carbon credits to be purchased from voluntary entities that verifiably are able to reduce their greenhouse gas emissions beyond a certain threshold compared to business as usual case. The percentage of offsets carbon credits that may be purchased from sources outside of California should have guidelines that assure the credibility and verifiability of the emissions reductions. The California businesses are integrated into the global economy should be able to reduce the net impact of carbon emissions through investments in other countries, such as in Clean Development Mechanisms in developing countries. The European Trading System on carbon credits has policies similar to this.

Importance of policies other than cap-and-trade

That California's most important and successful policy strategies pre-AB 32 have involved policies other than cap-and-trade, and the intent of AB 32 was clearly that these strategies should continue and be enhanced. Policies other than cap-and-trade have a crucial role in encouraging targeted innovation, and delivering targeted co-benefits such as improved air quality. The greenhouse gas emission externality is a cost not incorporated into the market and as such constitutes a market failure, and so placing a price on emissions will not be sufficient to ensure that California captures our lowest cost options. Thus, policies other than cap-and-trade, such as standards (clean cars, energy efficiency, renewable portfolio, and others), incentives, and mandates to name just a few examples, are crucial. We urge the MAC consider the effectiveness of other strategies in its thinking on which sectors should be included in the cap and trade and how the cap and trade should interact with other policies where appropriate

A clear criteria should guide the distribution of the emission reduction effort between cap-and-trade and other policy options.

Consideration of interaction of cap-and-trade with other polices

The issue of the importance of other polices naturally raises the question of integration of cap-and-trade with other policies. How does cap and trade interact with the State's other global warming policies, those underway and under development? To what extent is advance coordination necessary?

Meeting the Environmental Justice tests in the bill

There seems to be an underlying assumption that this can be done. What kind of analysis needs to be done? What safeguards need to be in place? How might auction revenue be used to help ensure that anti-backsliding provisions are respected? We encourage you to address these questions and to work closely with the EJ Advisory Committee.

Fairness in economic impacts

The bill also calls for avoiding disproportionate economic impacts on low income households. Of course, we recognize that both regulatory policies and cap and trade may have regressive impacts such as increases in energy prices, which typically hit low income households hardest. What analysis should be done with respect to regressive economic effects? How can cap and trade design elements, including but not limited to auctioning, offset or avoid disproportionate economic

impacts? What other measures would you recommend for redressing these?

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